



## Tax Notes Today

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### News Analysis: Federal Circuit Plays It Safe in En Banc Reconsideration of Bush

by Jeremiah Coder



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Summary by ~~taxanalysts~~

In news analysis, Jeremiah Coder looks at the Federal Circuit's en banc reconsideration of a case in which the IRS made adjustments to a partner's tax liability but never issued a notice of deficiency.

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The U.S. Court of Appeals for the Federal Circuit, sitting *en banc*, pulled back from the brink of earlier foolishness by holding August 24 that IRS adjustments to a partner's tax liability were computational adjustments that did not require a notice of deficiency to be provided.

The new holding reverses an earlier decision by the court's original panel that was much derided by the tax bar for creating a "harmless error" rule that had no apparent place in the statutory construction of the tax code. (For the *en banc* opinion in *Bush v. United States*, No. 2009-5008 (Fed. Cir. Aug. 24, 2011), see *Doc 2011-18161*  or *2011 TNT 165-7* .)

George A. Hani of Miller & Chevalier told Tax Analysts he was glad that the *en banc* opinion "jettisoned the 'harmless error' approach, as I feared the mischief such a rule could cause our tax system."

### Background

In *Bush*, the taxpayer and his deceased wife were among several partners in a 1980s purported tax shelter. The Bushes' participation in the partnership proceeding in Tax Court ended after they settled with the IRS and signed a closing agreement that made no changes to the reporting of partnership items. The IRS then made an assessment against the taxpayers for several years covered by the closing agreement based on the Bushes' at-risk capital amounts, but it never issued them a notice of deficiency. The taxpayers paid the tax liabilities and sued for a refund in the Court of Federal Claims.

Central to the case was whether the IRS was required to give the Bushes a notice of deficiency. Although the general rule is that it would be required to do so, section 6230(a)(1) exempts computational adjustments from the notification requirement unless the adjustment relates to affected items.

In deciding the parties' cross-motions for partial summary judgment, the Court of Federal Claims held that the IRS's adjustments were computational because the assessed liabilities were determined based on the closing agreement and the taxpayers' individual returns, and thus no deficiency notice was required. The case was one of two selected to serve as test cases for similarly situated partnership plaintiffs seeking refunds. (For the Court of Federal Claims opinion, No. 02-1041T (Aug. 17, 2007), see *Doc 2007-19230* or *2007 TNT 162-9*.)

On appeal, a majority of a Federal Circuit panel concluded that notice was required "because the assessments did not meet the definition of 'computational adjustment [s]' under section 6231(a)(6)." However, the court took a strange turn by holding that even if notice was required, "the IRS's failure to issue a notice of deficiency constituted harmless error under the circumstances of this case." The court said that although most collection circumstances require the IRS to provide notice -- the general absence of which "is both unauthorized and wrongful" -- the taxpayers' unusual refund position created by paying the assessment before collection was sought took the situation outside the scope of the normal deficiency rules. No automatic refund was contemplated by section 6213, so the lack of notice was not prejudicial to the taxpayers, the majority said. (For the original circuit court opinion (Fed. Cir. Mar. 31, 2010), see *Doc 2010-7106* or *2010 TNT 62-8*. For prior analysis, see *Doc 2010-7748* or *2010 TNT 69-1*.)

Righting a listing ship, the *en banc* majority, led by Judge Sharon Prost, who had concurred in the original decision but criticized the majority's legal analysis as "abstract and unapproachable," held that the IRS adjustments made under the closing agreements were computational adjustments that negated the need to issue notices of deficiency. The court concluded that no actual change to a partnership item was necessary for it to be considered computational. "What must change is the partner's tax liability, not necessarily the treatment of any partnership item," the court

said. (For prior coverage of oral arguments before the *en banc* circuit, see *Doc 2011-10120* or *2011 TNT 91-4*.)

The court was troubled by the notion of requiring a pre-assessment notice when tax liability changes without change to any of the underlying partnership items. If that were the case, "individual partners would be able to have a second pre-assessment bite at the apple," the majority wrote. Looking to its prior precedent in *Olson v. United States*, 172 F.3d 1311 (Fed. Cir. 1999), the court relied on the absence of any factual determinations -- because of the terms of the closing agreement and the parties' stipulations -- as further basis to find the government's action as merely computational. "A post-settlement adjustment is 'computational' because after the settlement, there is nothing left to do but perform a calculation to determine tax liability," the court said.

The majority was also not convinced that reg. section 301.6231(a)(6)-1T demanded that a change in the treatment of a partnership item fall within the computational bucket. Although such a change is often found as part of a computational adjustment, "nothing in the regulation demands that this be the only scenario," the court wrote.

The presence of the closing agreement seemed to finalize the court's decision, with the agreements establishing computational formulas for determining the taxpayers' tax liability. "After the settlement, there was nothing to do other than plug numbers into a formula," which was good enough to deem the changes computational adjustments, the court said.

Because the other three questions briefed as part of the *en banc* appeal all presumed that a deficiency notice was required, the court's holding on the first question made analysis of them irrelevant.

In a short dissent, four circuit judges argued that there was no computational adjustment because no partnership item was involved. The statutory definition of computational adjustment in section 6231 requires that a change in assessment cover a partnership-level item, but in this case, the stipulation between the parties involved only at-risk amounts of the individual partners, the dissent wrote.

Because settlement agreements are binding, requiring a deficiency notice does not turn the statute into an avenue for re-litigation, the dissent said, adding, "A right to a deficiency notice has nothing to do with whether there is merit to the taxpayer's underlying claim."

The dissent argued that the case should have been returned to the Court of Federal Claims to determine whether the statute of limitations period had run at the time the taxpayers made the voluntary payment in order to establish whether a refund was

owed.

### **Questioning TEFRA**

Daniel Wiles of PricewaterhouseCoopers LLP said both the majority's opinion and the dissent left much to be desired. "While the majority has colorable arguments for each step in their interpretation, when you step back, the big picture of [the 1982 Tax Equity and Fiscal Responsibility Act] makes no sense under their view," he said. The idea that the IRS could concede all adjustments made in the final partnership administrative adjustment, yet come back and summarily make changes to partner-level items through a computational adjustment, is "plain wrong," he said.

Stuart J. Bassin of Baker & Hostetler LLP said the opinion "shows once more that TEFRA has failed in its fundamental goal of efficiently resolving partnership disputes." Because the difficulty of construing the rules continues to create judicial uncertainty, "Congress and the Service need to fix the TEFRA regime," he said.

Bassin also said the Federal Circuit's disposition of the case "further reminds us that practitioners need to pay close attention to procedural questions raised by the TEFRA system." The case was unusual because the taxpayers had settled with the IRS in 2000 and did not challenge the IRS's proposed computations but sought to avoid any tax liability by claiming that the government had committed a technical procedural error in assessing the liability, he said.

### **Ridiculing Harmless Error**

Hani said it was inconceivable that the earlier decision concluded that a notice of deficiency was required but that the failure to provide one was harmless error, he said. "The only way that could be harmless is if the taxpayer could otherwise find a way into Tax Court, but that too is inconceivable to me without a notice of deficiency," he said, arguing that some rules "just have to be black and white, with no exceptions, for our system to function smoothly. This is one of them."

Although Prost mentioned in her prior concurring opinion and again when writing for the majority in the new opinion that neither party had raised the harmless error idea, Hani said it shouldn't matter whether either party advanced the rationale that forms the basis for a court's conclusion. "Judges are free to decide cases for the right reasons, and the strength of the rationale should not depend upon whether the judge thought of it on his or her own or whether one of the parties briefed the issue," he said. "In this case, the harmless error approach was a bad idea, but not because neither of the parties raised it."

The absence of discussion of the harmless error rule masks the fact that the majority subtly used "a variation of it in getting to their conclusion," Wiles said. In looking at

the settlement agreement's formula, "the court is looking at the outside facts of the case and finding that none of the events that would have caused a difference under the agreement actually occurred," he said. By assuming away any partner-level facts that might have influenced the outcome, the court suggests that "there was no harm in not looking for them," he said.

Carlton M. Smith, director of the Benjamin N. Cardozo School of Law Tax Clinic, was happy to see that the harmless error rule wasn't repeated in the latest opinion, either by the majority or the dissent. "Both parties had attacked the use of the harmless error statute in title 28, and I also said it was unnecessary in my amicus brief," he said. (For Smith's amicus brief, see *Doc 2010-27486* or *2010 TNT 249-9*.)

Smith praised the dissent for citing *Lewis v. Reynolds* "as the solution to this case if a notice of deficiency had to be issued; that omission was something that jumped out at me and Professor Bryan Camp." Smith noted that the original opinions that were vacated (both the majority and concurrence) didn't even discuss *Lewis*. "*Lewis* prevents a refund, even if there were certain procedural errors, unless there is an actual overpayment. The only overpayments here were some payments made after the statute of limitations expired," he said.

Smith said he was troubled by the court's notion that payment in the case was made voluntarily. "Payment was made under threat of the IRS's considerable post-assessment collection powers of lien and levy," he said. "I don't like the voluntary/involuntary distinction as to when 6213(a) comes into play requiring a proper court, including the Tax Court, to refund anything collected after a notice of deficiency should have been issued but was not. I thought the better view was that the Court of Federal Claims was not a 'proper court' under 6213(a)'s injunctive sentence, so had no enforcement powers as to that statute and should avoid discussing it."

### **Parsing Closing Agreements**

Wiles faulted the parties' closing agreement for contributing to the poor judicial analysis of TEFRA rules. "We generally recommend to our clients that agreements to vary from the TEFRA processes specifically provide that TEFRA procedures are not to apply, and specify how underpayments are to be determined and paid," he said. The court should have found TEFRA irrelevant in light of the finality of the agreement under section 7121 and simply interpreted the closing agreement, he said. That would have led to the recognition that "the deficiency procedures are so ingrained in our tax jurisprudence, there should have been an assumption of those proceedings unless the closing agreement specifies otherwise," Wiles said. "This is so fundamental that the fact that there would be no tax refund under *Lewis v. Reynolds* refund principles should not excuse it; failure to issue a valid notice should never be harmless error."

Wiles also said that the majority erred in its conviction that there were no factual inquiries necessary at the partner level in the case. Portions of the agreement cited by the lower court show that "there could have been great variances in the losses to be allowed depending upon a number of factual occurrences," he said. "The fact that the agreement contained a formula for which numbers were to be 'plugged in' does not eliminate the possibility of disagreements on what those numbers are -- they were not provided in the agreement, and I sincerely doubt they all could be derived by looking at the partner's return."

Ultimately, Wiles chalked up the unsatisfying outcome to the incomplete closing agreement that allowed the parties to later argue over procedural ambiguities. "The court gets to the correct tax, but does so in a way which does great harm to the resolution process," he said.

According to statistics provided on the Federal Circuit's website, the court typically grants fewer than six *en banc* petitions out of more than 150 such petitions filed each year. It was fortunate that the Federal Circuit was wise enough to correct the major misstep of the original panel by dropping harmless error as a determinative rationale and sticking to interpreting the tax code, even if tax lawyers might disagree with its final analysis.

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## Tax Analysts Information

**Code Sections:** Section 6230 -- Partnership Administrative Changes  
Section 6231 -- Partnership Item Definitions  
Section 6402 -- Authority to Make Refunds

**Jurisdiction:** United States

**Subject Areas:** Litigation and appeals  
Partnership taxation  
Practice and procedure

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